DOT-4

BEFORE THE
SURFACE TRANSPORTATION BOARD
WASHINGTON, D.C.

UNION PACIFIC CORPORATION, UNION PACIFIC RAILROAD COMPANY AND MISSOURI PACIFIC RAILROAD COMPANY -- CONTROL AND MERGER -- SOUTHERN PACIFIC RAIL CORPORATION, SOUTHERN PACIFIC TRANSPORTATION COMPANY, ST. LOUIS SOUTHWESTERN RAILWAY COMPANY, SPCSL CORP. AND THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY	)	Finance Docket 32670, et al.

BRIEF OF THE
UNITED STATES DEPARTMENT OF TRANSPORTATION

Congress has broadly charged the United States Department of Transportation ("DOT" or "Department") with providing "leadership in identifying and solving transportation problems" as well as "in the development of transportation policies and programs." 49 U.S.C. §§ 101(b)(5) and 301(2), respectively. In carrying out this general responsibility the Department seeks to promote the long-term development of a balanced transportation system to serve the nation. DOT's participation in this and similar proceedings is one critical element in that effort.

The Department carefully scrutinizes proposed railroad mergers to ensure that they are consistent with the public interest. The instant consolidation, if approved, would create the largest railroad system in the United States. It is the latest in a long trend of rail mergers in the West, all of which DOT has closely evaluated in order to determine their public interest impacts. In this, as in previous cases, the Department's evaluation encompasses not only the terms of the proposal itself, but also the longer-term impact of the proposed merger on the national transportation system, including competition, service to shippers, and other matters.

The Department previously submitted its preliminary comments on the pending consolidation, in which it noted some of the issues presented in this proceeding but reserved its position on the merits for its brief. In this brief the Department addresses the central issues in the proceeding: the merger's likely effects on competition and the appropriate remedy therefor. [1] DOT has concluded that the merger will substantially reduce competition in large regions of the country. Consequently, even though there may be substantial benefits that would flow from the merger, the Department opposes the merger unless the Board imposes conditions to remedy these competitive losses. Under the circumstances of this case, DOT believes that the Board must condition any approval in two significant respects. First, the STB must order divestiture of the lines

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[1]/ DOT has already submitted its views on the consolidation's impact on the environment and safety and recommended mitigation measures. DOT-3, filed May 9, 1996.

of track in the Texas Corridors, and second, it must significantly strengthen the trackage rights proposed in the Central Corridor. Without such conditions, the Department believes that the Board should not approve the merger.

I. INTRODUCTION

On November 30, 1995, Union Pacific Corporation ("UPC"), Union Pacific Railroad Company ("UPRR"), Missouri Pacific Railroad Company ("MPRR)"), Southern Pacific Rail Corporation ("SPR"), Southern Pacific Transportation Company ("SPT"), St. Louis Southwestern Railway Company ("SSW"), SPCSL Corp. ("SPCSL"), and The Denver and Rio Grande Western Railroad Company ("DRGW") [2] (collectively "Applicants") filed an application seeking approval and authorization under 49 U.S.C. §§ 11343-45 for: (1) the acquisition of control of SPR by UP Acquisition Corporation ("Acquisition"), an indirect wholly owned subsidiary of UPC; (2) the merger of SPR into UPRR; and (3) the resulting common control of UP and SP by UPC. [3]

The Interstate Commerce Commission ("ICC" or "Commission") accepted the application in Decision No. 9, served December 27, 1995. Thereafter the ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803, abolished the ICC and

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[2]/ UPC, UPRR, and MPRR are referred to collectively as Union Pacific. UPRR and MPRR are referred to collectively as "UP." SPR, SPT, SSW, SPCSL, and DRGW are referred to collectively as Southern Pacific. SPT, SSW, SPCSL, and DRGW are referred to collectively as "SP".

[3]/ SPT is a wholly owned subsidiary of SPR. SPCSL and DRGW are wholly owned subsidiaries of SPT. SPT owns 99.9% of SSW.

established as its successor agency the Surface Transportation Board ("STB" or "Board"). See Decision No. 11, served February 2, 1996, at note 1. That statute required that the Board assess this merger pursuant to the substantive provisions previously in place. Section 204(b) of P.L. No. 104-88. The Board adopted the expedited procedural schedules originally set by the ICC in Decision No. 6, served October 19, 1995.

The UP operates approximately 22,000 miles of railroad track in the Western United States. Its main lines comprise more than 17,000 miles, and extend from all major West Coast ports through the so-called "Central Corridor" to the Midwest and Southwest, as well as the Texas and Louisiana Gulf. Major cities served include Los Angeles, Oakland, Seattle, Portland, Denver, Kansas City, St. Louis, Chicago, New Orleans, Memphis, Dallas, Houston, and Laredo. UP/SP-22 at 40-41. The principal commodities handled by UP include coal, forest products, chemicals and plastic, and grain. UP/SP-22.

The SP operates more than 16,500 miles of railroad track in the West, Midwest, and Southwest. Its main lines run between Portland and Los Angeles, from the Bay Area in California through the Central Corridor (traversing Nevada, Utah, Colorado, and Kansas) to the Midwest, and along the "Southern Corridor" from Los Angeles to El Paso, Texas, and thence through the Midwest to Chicago as well as on to Texas and Louisiana. UP/SP-22. In addition to the cites named above, SP serves Dallas/Ft.

Worth, Houston, Laredo, St. Louis, Kansas City, Denver, Salt Lake City, Memphis, and five gateways to Mexico. UP/SP-22 at 41-43. SP principally transports forest products, grain, coal, automotive and intermodal traffic, chemicals, and plastics. UP/SP-22, Verified Statement ("VS") of Gray at 215-228.

The Applicants have submitted statements of support from some 1,300 shippers, state and local government agencies, shortline railroads, and other organizations. UP/SP-25; UP/SP-36; UP/S-233. [4] They claim that the merger offers public benefits in excess of $750 million annually. These benefits include expanded single line service, shorter routes and reduced transit times, greater service reliability and quality, reduced costs, and increased efficiency. UP/SP-22, Appendix A; UP/SP-23 and-24.

The Applicants contend that the creation of the rail carrier formed by the consolidation of the Burlington Northern Railroad Co. and the Atchison, Topeka and Santa Fe Railway Co. ("BNSF") has introduced a competitor that UP and SP individually can never hope to match. Moreover, SP in their view is a financially weak and operationally inferior railroad that not only cannot offer vigorous

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[4]/ E.g., Ciba-Geigy Corporation, General Mills, Inc., General Motors Corp., the ports of Portland and Seattle, Yellow Freight System, Inc., Bechtel Corporation, the California Attorney General, the Governors of Arizona, Arkansas, Idaho, Louisiana, Nebraska, New Mexico, and Wyoming, the Georgetown Railroad Co., ConAgra, Inc., and Minnesota Mining & Manufacturing Co. Inc.

competition, but also is unlikely to remain viable as an independent railroad. The merger will therefore enable the combined UP and SP systems to provide strong competition against BNSF, improve service to SP shippers and many others, and introduce new and efficient routes throughout the West. UP/SP-22, VS of Davidson at 167, VS of Gray at 232-36, VS of Anschutz at 182-86.

An important element of the transaction before the Board is an agreement entered into between the Applicants and BNSF. The signatories primarily intend for this agreement to address the competitive consequences of the merger. BN/SF-1, VS of Ice and VS of Lawrence; UP/SP-22, VS of Rebensdorf and VS of Peterson. This agreement grants trackage rights and sells rail line to BNSF that total more than 4,000 miles, an unprecedented distance. The result of this, the Applicants contend, is that every shipper previously served by both UP and SP and no other railroad will continue to be served after the consolidation by two rail carriers, UP and BNSF. [5] The lines at issue extend from the Bay Area to west of Denver, Colorado (the "Central Corridor"), and reach from Houston (1) west to Eagle Pass, Texas, (2) south to Brownsville, Texas, (3) east to New Orleans, and (4) north to Memphis, Tennessee. UP/SP-22, VS of Rebensdorf; BN/SF-1, passim. (For convenience, we refer to these areas as "the Texas Corridors.") Through the purchase of discrete segments of track, the BNSF

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[5]/ The agreement also grants trackage rights on some BNSF lines to the Applicants. Id.

agreement also creates new single-line service in the so-called "I-5 Corridor" along the Pacific Coast. The Applicants have requested that the STB make this agreement a condition of approval of the pending merger.

Subsequently, a settlement agreement between the Applicants and the Chemical Manufacturers Association ("CMA") materially amended the BNSF agreement. UP/SP-219. The CMA modifications would permit BNSF to operate trains on UP and SP lines from the Texas Gulf Coast to Memphis and on to St. Louis in the same "directional flow" highlighted in the Applicants' Operating Plan; it would expand the storage facilities made available to BNSF in the Texas Gulf; it would stipulate the uses of the trackage rights fees paid to Applicants by BNSF; and it would take specific measures to avoid dispatching and related problems to which landlord and tenant railroads are sometimes susceptible. Id; UP/SP-219. The Applicants would also make this modification a condition of approval of the merger.

Opposition to the merger in whole or in part arises from railroads, public bodies, shippers and shipper organizations, and public utilities, among others. Examples of these parties are: the Kansas City Southern Railway ("KCS"), Montana Rail Link ("MRL"), the Railroad Commission of Texas ("RCT"), the National Industrial Transportation League ("NITL"), the Society of the Plastics Industry ("SPI"), the Western Coal Traffic League ("WCTL"), the Western Shippers' Coalition ("WSC"), the Texas Utilities Electric Co., Inc., Dow Chemical Company, Kenecott

Energy Company, Wisconsin Power and Light Co./Wisconsin Public Service Corp., Consolidated Rail Corporation ("Conrail"), Union Carbide Corporation, and Entergy Services. These parties contend that the merger will cause competitive harm by reducing the number of railroads in parallel UP and SP corridors and that the BNSF trackage rights agreement is not sufficient to maintain strong intramodal competition in the affected areas. The opponents also argue that shippers in these corridors will lose transloading and build- in/build-out options, which have been used for competitive leverage to gain reductions in rail rates.

The United States Department of Justice ("DOJ" or "Justice Department") has submitted evidence from which it concludes that the proposed transaction, even as modified by the BNSF agreement, would substantially reduce competition. The Justice Department analysis concluded that competitive problems would exist in those areas-where the consolidation would reduce the number of railroads serving shippers from three to two, and from two to one, that the BNSF agreement either did not address or was otherwise inadequate to remedy these problems, [6] that the Applicants had overstated the merger's public benefits, and that the SP is and could remain a viable independent competitor if the transaction is not approved. DOJ-8. DOJ reserved for the brief its ultimate position on the merger.

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[6]/ DOJ made its filing before the Applicants modified the BNSF agreement by their settlement with the CMA.

II. SUMMARY OF ARGUMENT

The proposed merger would combine two of the three largest Class I railroads remaining in the West. The Applicants themselves have maintained that this transaction was prompted by the ICC's decision last year to approve the merger of the Burlington Northern Railroad Company and the Atchison, Topeka and Santa Fe Railway Company. Finance Docket No. 32549, Burlington Northern, Inc. and Burlington Northern Railroad Co. --, Control and Merger -- Santa Fe Pacific Corp. and the Atchison, Topeka and Santa Fe Railway Co. (served August 15, 1995), slip opinion ("BN/SF"). To the extent that is true, there is reason to suspect that the instant merger might have a like effect on other rail carriers. For these and other reasons, the consequences of the Board's decision in this case on rail transportation and the economies of many regions and industries will be particularly substantial and lasting. Given the diminishing numbers of Class I railroads and the real possibility that the trend toward Class I rail mergers may yet continue, the Department believes that it is incumbent upon the Board to broaden its analytical perspective so that, in addition to the exacting competitive scrutiny to which the STB will subject this merger, it also considers the future of rail transportation in the United States in reaching its decision.

In carrying out its leadership role in setting national transportation policy, the Department has carefully analyzed the likely competitive effects of the proposed merger on the country's transportation system. Based on that review, DOT has concluded that in its present form the pending consolidation would substantially reduce competition in extensive areas of the country. The Department therefore submits that the merger would be consistent with the public interest and warrant approval only if it is subjected to the critical and substantial conditions discussed herein.

To a major extent this proceeding concerns a consolidation of two largely "parallel" railroads that compete head-to-head with each other over extensive areas of the country. Such transactions traditionally pose more competitive problems than so-called "end-to-end" mergers involving rail carriers that directly compete with each other in relatively few areas. [7] Although the parties may dispute the significance of the competitive problems posed by this transaction, especially where the number of railroads competing in a market is reduced from three to two, there is broad agreement that where the merger would reduce the number of competing railroads from two to one a remedy to preserve competition is absolutely necessary.

The evidence on the competitive impacts in markets where the number of rail carriers would go from three to two is inconclusive. However, two independent

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[7]/ Cf. , e.g., BN/SF , slip op. at 52, and Finance Dkt. No. 32133, Union Pacific Corp. Union Pacific Railroad Co. and Missouri Pacific Railroad to -- Control -- Chicago and North Western Transportation Co. and Chicago and North Western Railway Co. (served March 7, 1995), ("UP/CNW") slip opinion at 70 with Santa Fe Southern Pacific Corp. -- Control -- Southern Pacific Transportation Co., 2 I.C.C. 2d 709 (1986)("SF/SP").

railroads in any given market has, in the past, usually proven to be sufficient to maintain vigorous competition. Consequently, the Department does not believe that this merger's reduction in the number of rail competitors from three to two requires relief from the Board.

The Department does, of course, recognize that two unaffiliated railroads are essential to preserve intramodal competition. In the circumstances of this case, however -- where the traffic volume is huge, the distances involved enormous, and there is no other remotely comparable railroad in the West -- DOT submits that the public interest requires that those two railroads must each be completely independent and on an equal competitive plane. In other words, the landlord-tenant relationship that is inherent in a trackage rights proposal is inadequate to the task. The tenant carrier is simply at an inherent disadvantage vis-a-vis the landlord. That disadvantage may well be surmountable in more commonplace situations (*i.e.*, where traffic volumes are lower, where distances are shorter, where there are, ultimately, other suitable railroads).[8] But it is critical here, where the agreement is by far the largest trackage rights arrangement ever contemplated and where two carrier competition would be utterly dependent upon its viability. In such circumstances the difficulties

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[8]/ It is important as well to note that voluntary trackage rights agreements between railroads are almost always limited to overhead traffic, which further reduces the competitive friction, if any, that might otherwise exist between the participants.

facing a tenant railroad are magnified tremendously. Moreover, BNSF's stance in this proceeding to date raises questions about the seriousness of its intentions to compete aggressively. Accordingly, the Department opposes the proposed merger unless the Board directs the Applicants to divest either the UP or the SP parallel lines of track in the Texas corridors. Because circumstances unique to the Central Corridor militate against divestiture of that line, DOT urges the STB to modify the trackage rights agreement between the Applicants and BNSF so as to position BNSF as a "landlord" or owner on that Corridor to the extent possible. If the Board is not prepared to strengthen these rights in this fashion, it should order divestiture of the Central Corridor as well.

III. APPLICABLE STANDARDS

The Interstate Commerce Act ("the Act") requires the Board to approve consolidations involving Class I railroads that it finds to be "consistent with the public interest." 49 U.S.C. § 11344(c). The Act and ICC precedent further define that broad standard. [9] The Act expressly directs the STB in its consideration of the public interest to take into account the following factors in the context of a proposed merger: (1) the

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[9]/ As noted, the ICC Termination Act did not amend the substantive standards applicable to this merger. It also preserved ICC precedent and made that precedent applicable to the STB unless and until changed by the Board. Section 204(a) of P.L. No. 104-88.

effect of the proposed transaction on the adequacy of transportation to the public; (2) the effect on the public interest of including or failing to include other rail carriers in the area involved in the proposed transaction; (3) the total fixed charges that result from the proposed transaction; (4) the interest of carrier employees affected by the proposed transaction; and (5) whether the proposed transaction would have an adverse effect on competition among rail carriers in the affected region. 49 U.S.C. § 11344(b)(1). See also BN/SF, slip op. at 51; UP/CNW, slip op. at 53; Finance Docket No. 32133, Union Pacific Corp., Union Pacific Railroad Co. and Missouri Pacific Railroad Co. -- Control -- Missouri-Kansas-Texas Railroad, 4 I.C.C. 2d 409, 426 (1988) ("UP/MKT"), *pet. for review dismissed sub nom.*, Railway Labor Executive Assn. v. I.C.C., 883 F.2d 1079 (D.C. Cir. 1989).

The Act also lists 15 elements that together establish as the nation's rail transportation policy an emphatic "reliance on competitive forces, not government regulation, to moderate railroad actions and to promote efficiency." UP/MKT, 4 I.C.C. 2d at 427 (citation omitted); see also BN/SF, slip op. at 52; UP/CNW, slip op. at 54. This reliance on competitive forces underscores the important role played by antitrust principles in the agency's consideration of merger cases. [10] See McLean Trucking Co. v. United States, 321 U.S. 67, 87 (1944); BN/SF, slip op. at 52-53; UP/CNW, slip op.

[10]/ The Act immunizes from the antitrust laws and other laws, as necessary, transactions approved by the STB. 49 U.S.C. § 11341(a).

at 54; UP/MKT, 4 I.C.C. 2d at 427. While the Board (like the Commission) does not sit as an antitrust court, its obligations under the Act's public interest standard require it to engage in a balancing of a transaction's potential public benefits as against its potential public harms, including the loss of competition. Railroad Consolidation Procedures, 363 I.C.C. 784 (1981), codified at 49 C.F.R. § 1180.1. [11] Public benefits derive from operating efficiencies and marketing opportunities that can make the consolidated carrier a more formidable competitor. BN/SF, slip op. at 51; UP/CNW, slip op. at 56; UP/MKT, 4 I.C.C. 2d at 428. Public harms most often arise from significant reductions in competition and serious threats to an unaffiliated rail carrier's ability to provide essential services. Id. [12]

Moreover, the Board has broad authority to impose conditions on its approval of a merger proposal in order to ensure that the public interest standard is met. 49 U.S.C. § 11344(c). Applicable precedent recognizes that conditions may reduce the benefits of a merger, however, and thus conditions are imposed to mitigate public

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[11]/ The STB in particular focuses on intramodal competition where long-haul movements of bulk commodities are concerned. 49 C.F.R. § 1180.1(c)(2)(i).

[12]/ An essential rail service is one for which there is a sufficient public need but for which adequate alternative transportation is unavailable. 49 C.F.R. § 1180.1(c)(2)(ii). The Texas Mexican Railway Company has contended that the merger would likely cause it to go out of business, resulting in a loss of essential services. TM-23. DOT takes no position on this issue; we urge the Board to review the record on this point carefully.

harm only when specified criteria are met. In the face of merger-induced reductions in competition or a loss of essential services, corrective conditions are appropriate when they will (1) effectively ameliorate the adverse effects, (2) be operationally feasible, and (3) produce public benefits that outweigh any reductions they might engender in the public benefits produced by the transaction. Union Pacific -- Control -- Missouri Pacific; Western Pacific, 366 I.C.C. 459, 562-65 (1982) ("Union Pacific Case"); 49 C.F.R. § 1180.1(d)(1). See also BN/SF, slip op. at 55-56.

Finally, rail consolidation proceedings under the Act require a "forward-looking assessment." SF/SP, 2 I.C.C. 2d at 744. That is inevitable, for the Board in these cases is attempting to review the likely effects of a proposed -- not a completed -- transaction as the agency determines its consistency with the public interest. The circumstances in which the instant merger comes to the STB make this perspective on the future even more important than in past cases.

The passage of the Staggers Rail Act of 1980 reduced government regulation and greatly assisted in the rationalization and revitalization of the railroad industry. Part of that process has been the reduction in the number of Class I railroads or railroad systems from twenty-six to ten.[13] Precedent and policy combined during this time to ensure that each merger that was approved was conditioned in the manner

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[13]/ Eight of these carriers have been merged into other railroads or railroad systems, and eight have been lost through reclassification by the ICC.

necessary to maintain competition as well as essential services. The Department believes that the same statutory and policy requirements that make concern for competition the centerpiece of ICC/STB scrutiny of mergers now require a distinct awareness of the present composition of the Class I railroad industry in the United States. As rail carriers become fewer and larger, the intramodal competition that may be necessary to mitigate adverse effects of consolidations among these giants is more likely to be found only in the larger railroads. [14]

The number, geography, financial strength, operating and marketing capabilities, and other such aspects of Class I railroads become more than just relevant and material; they become critical because of the scale in which these transactions are played out. [15] Indeed, should this merger proceed without adequate safeguards it is

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[14]/ The instant merger is illustrative of this point. The large areas of overlap in the UP and SP systems caused the Applicants to cast about for an unaffiliated railroad that could truly maintain effective competition. The distances involved, operational and financial capabilities, and similar factors dictated to those most directly affected -- the shippers -- that only BNSF could meet this standard. UP/SP-22, VS of Rebensdorf at 292-96. The resulting trackage rights agreement is unprecedented in its scope.

[15]/ Again, the merger at issue reflects this; the Applicants have strenuously contended that their consolidation was prompted (if not necessitated) by the creation of the nation's largest railroad, the BNSF system. UP/SP-22, VS of Davidson at 162-63. Only by responding in kind, they assert, could they hope to compete. UP/SP-23, VS of Peterson at 11.

very possible that large numbers of shippers would face non-competitive rates and services, which in turn could lead to a return of greater industry economic regulation. The Department therefore urges the Board to weigh carefully the implications its decision in this matter may have, not only on the immediate consequences of this merger, but also on the future composition of the railroad industry throughout the nation and the resulting impact on the adequacy of transportation to the public.

The regulatory provision regarding "cumulative impacts and crossover effects" does not dictate otherwise. 49 C.F.R. § 1180.1(g). DOT is not asking the STB to consider any event that has occurred during the pendency of this proceeding. We are asking the Board to focus on the full impacts of transactions, both those that have "already" occurred and the one now before it.

Should the STB nonetheless feel constrained by this provision, it is well established that an agency "faced with new developments or in reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrative rulings and practice." American Trucking Ass'ns v. Atchison Topeka & Santa Fe Ry, 387 U.S. 397, 416 (1967). See also Building & Construction Trades' Dept., AFL-CIO v. Donovan, 712 F.2d 611, 619 (D.C. Cir. 1983). Clearly a broader view is now required. We no longer have twenty-six Class I railroads or railroad systems, and precedent and rules that were established at that time do not necessarily provide the proper guidance as the Board looks toward the future of rail transportation in this nation. In a similar context, the D.C. Circuit has recently held that when the legitimacy of past agency policy is called into question the agency "must always stand ready "to hear new argument" and "to examine the basic propositions undergirding the policy." Bechtel v. FCC, 10 F.3d 875, 878 (D.C. Cir. 1993) *quoting* McLouth Steel Products Corp. v. Thomas, 838 F.2d 1317, 1321 (D.C. Cir. 1988). Such reconsideration is clearly warranted in circumstances where the number of Class I railroads has so shrunk that there are now only three Western roads, three Central U.S. roads, and four Eastern roads.[16]

IV. THE PROPOSED MERGER THREATENS TO REDUCE COMPETITION SUBSTANTIALLY IN LARGE REGIONS OF THE COUNTRY

A. The Proper Analytical Framework

The importance of competitive analysis in the Board's assessment of the public interest in rail merger proceedings is evident from the final decision reached by the ICC in every such case. In those decisions the ICC drew heavily upon antitrust law and precedent by recognizing that competition takes place, and so is measured, within markets.

16/ Not only is the diminished population of Class I carriers a basis for arguing a new approach, the prospect of future transcontinental mergers also may warrant a new approach.

> Because competition takes place within economic markets, we must define the economic markets that would be affected by [a proposed consolidation]. A relevant market is the area of effective competition, and necessarily has two dimensions, product and geographic. Generally, two products, whether they are goods or transportation services, are in the same market if they are close substitutes. The closeness of substitution is measured (in principle, though only imperfectly in practice) by the extent to which consumers shift their consumption in response to a change in relative price or quality.

UP/MKT, 4 I.C.C. 2d at 432; UP/CNW, slip op. at 57. See also BN/SF, slip op. at 55.

1. The Relevant Product Market

The relevant product market for assessing the competitive effects of proposed consolidations includes all products that are "reasonably interchangeable." UP/MKT, 4 I.C.C. 2d at 432, *citing* United States v. E. I. Dupont de Nemours Co., 357 U.S. 377, 395 (1959). In other words, if buyers of a product can turn to another product and/or another supplier and thus prevent a merged firm from sustaining a price increase, then the definition of the market must be expanded to include the additional product or supplier. The product provided by railroads is the transportation of freight. In past railroad merger proceedings, the Commission did not apply a single, fixed definition of the relevant market, but instead examined the specific circumstances and the evidence of record in each instance, to determine whether the relevant market was confined to rail freight transportation or was broad enough to include other transportation modes or products. See UP/CNW, slip op. at 57; UP/MKT, 4 I.C.C. 2d at 433-34 and cases cited therein. This approach guides the Board as well.

At the same time, the STB is specifically required under 49 U.S.C. §

11344(b)(1)(E) to examine the effect of a transaction on "competition among rail carriers in the affected region." The Commission observed in this regard that the intent of the nation's Rail Transportation Policy (49 U.S.C. § 10101a) is "to ensure the development and continuation of a sound rail transportation system with effective competition among railroads and with other modes." SF/SP, 2 I.C.C. 2d at 721. Therefore, in reviewing rail consolidation proposals the Board, like the Commission, should consider competition among rail freight carriers before and after the proposed transaction as a primary basis for its assessment of the public interest.

The Applicants point out that for some traffic only carriage by rail is appropriate, while for other cargo transportation by other modes is feasible; the critical factors are the commodities hauled and the distances involved. UP/SP-23, VS of Barber at 463. However, they also assert that shippers of large volumes of the traffic at issue (forest products, grain, chemicals, and intermodal traffic) have alternatives to rail: truck, water, and joint truck/rail. Id.

In addition to the Applicants, in this proceeding the Justice Department, KCS, and the NITL have formally defined the relevant product market. DOJ recognizes that for some movements truck and barge transportation can be substituted for rail to constrain the merged railroads from increasing rates to a non-competitive level. DOJ-8, VS of Majure at 4. Consequently, DOJ's analysis includes trucks in the relevant product market for shipments of manufactured products moving under 500 miles. [17]

KCS rejects the inclusion of modes other than rail in the relevant product market, asserting that the characteristics of the commodities and length of haul render motor carriers ineffective competitors for any shipments. KCS-33, VS of Grimm at 206-208. Barge transportation is also excluded on the assumption that it does not compete in the principal territory served by the merging railroads. Id.

In general the Department agrees with the Applicants that other modes -- truck and barge -- can effectively constrain rail rates for certain traffic, and some evidence in the record supports that position. UP/SP-23, VS of Peterson, Appendix A. However, it is an unfortunate fact that detailed data on truck movements, which account for eighty cents of the nation's freight dollar, are simply not available. The evidence of record is either anecdotal or so general that it is not dispositive for assessing competition for particular commodities moving over designated origin-destination

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[17]/ DOJ's assumption that trucks do not compete with rail at distances exceeding 500 miles appears overly conservative. Rail intermodal service competes most closely with trucks and it is widely recognized that doublestack container trains provide the lowest cost, most truck-competitive service. A well-received 1990 study commissioned by DOT's Federal Railroad Administration determined that this service does not begin to compete with trucks (on a cost basis) until the rail linehaul exceeds 730 miles, and that assumes a dray of only 30 miles at either end of the move. Manalytics, Inc., Double Stack Container Systems: Implications for U.S. Railroads and Ports (1990); FRA-RRP-90, available through the National Technical Information Service. Moreover, Applicants' evidence displaying tonnage moved region-to-region by rail, truck, and barge, clearly reveals rail-truck competition over very long distances, *e.g.*, from California to the Northeast quadrant of the country. UP/SP-23, VS of Peterson, Appendix A, Regional Traffic Flow Data Table.

routings. Therefore, based on the evidence submitted by the parties, the Department submits that the relevant product market in this proceeding is restricted to rail freight transportation.

2. The Relevant Geographic Market

The geographic market is the area in which suppliers of a service or product operate, and to which buyers can turn to meet their requirements. Competitive analysis must also encompass any "economically significant submarket" where the transaction may substantially lessen competition. UP/MKT, 4 I.C.C. 2d at 435. As the ICC noted in the Union Pacific Case, 366 I.C.C. at 505, "the distinctions between product and geographic markets are not as clear in transportation as they are in other industries, for carriers, in particular railroads, effectively sell their geography." Thus the determinations of the relevant product market and the relevant geographic market in a particular case will necessarily be interrelated. In analyzing the geographic market, the ICC has analyzed traffic flows between city pairs, as well as flows in rail corridors, and at specific points in the area in which merging rail firms operate. UP/MKT, 4 I.C.C. 2d at 437.

The Applicants have defined the relevant geographic market fairly narrowly, focusing for the most part on Standard Point Location Codes at the six digit level ("SPLC-6") [18] -- *i.e.*, individual rail stations or shippers -- served by both UP and SP

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[18]/ The Association of American Railroads has established Standard Point Location Codes ("SPLCs") to provide each location in the country that originates or terminates traffic a unique

and no other railroad. However, they recognize that these points generally tend to congregate along areas where their rail lines overlap, thereby defining corridors with end points at relatively large population and traffic-generating centers. UP/SP-23, VS of Peterson at 12-15.

Other parties proffer broader relevant markets. The Justice Department concentrates on the origins and destinations of the major traffic carried by UP and SP and varies its geographic definition depending on the movement at issue. For commodities that DOJ believes capable of being trucked longer "nontrivial" distances to reach a competing railroad (e.g., grain and manufactured products), it considers "BEA" origin - destination pairs [19] as the relevant geographic market. For those relatively fewer commodities that DOJ believes can economically be trucked only a short distance (e.g., coal, chemicals, and plastic), it considers Standard Point Location Code pairs at the four digit level ("SPLC-4") -- *i.e.*, counties -- to be the relevant

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number for ease of identification. Generally, states are designated by two digits, counties by four digits, and individual points or shippers by six digits.

[19]/ The Department of Commerce's Bureau of Economic Analysis has defined business economic areas ("BEAs") to facilitate regional economic analysis. A center of economic activity is the base of each BEA, while surrounding counties that are economically related to the center (by factors such as journey-to-work patterns, and metropolitan newspaper circulation) are included in a BEA. BEAs are comprised of ten to thirty counties; their area varies from 2,000 to over 65,000 square miles.

geographic market. DOJ-8, VS of Majure at 4-8.

KCS defines a broader geographic market than the Justice Department, maintaining that BEA origin-destination pairs comprise the relevant market for the movement of all commodities. KCS-33, VS of Grimm at 182-188. The National Industrial Transportation League ("NITL") defines the relevant geographic market as the regions, shipping points, corridors, and origin-destination markets that UP and SP serve, and therefore, to NITL, in which they compete. NITL-9, VS of Shepard at 34.

Based on the evidence submitted by the parties and our own analysis, (discussed further in the section of this brief addressing competition) the Department submits that the relevant geographic market consists of points and parallel corridors where UP and SP compete, and where the merger would reduce the number of carriers from two to one. The corridors identified in DOT's analysis generally correspond with those identified by Applicants, but include points exclusively served by UP or SP as well as the commonly served points identified by Applicants. Specifically, we believe the relevant geographic market in this proceeding is inclusive of the portions of the north-south corridor along the West Coast ("the I-5 Corridor"), the Central Corridor from Denver, Colorado to Oakland, CA; and the Texas Corridors. [20] Other areas in

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[20]/ The Texas Corridors consist specifically of the UP and SP lines in southeast and central Texas from Houston to Brownsville and Waco to San Antonio and Eagle Pass; the Applicants' lines in the corridor from New Orleans into east Texas; and their lines in the corridor from Houston to Memphis.

which the merger reduces the number of railroads from two-to-one (hereinafter "two-to-one" points or areas) include two-to-one points in Arkansas and Missouri, and the stretch from El Paso to Sierra Blanca, Texas.

B. <u>The Merger's Impact on Competition Generally</u>

The proposed merger will reduce the number of railroads in many markets in the West from three to two and in many others from two to one. The Department considers that there is insufficient evidence to demonstrate that the reduction in the number of railroads from three-to-two brought about by this merger should be cause for the Board's concern. However, there is some uncertainty on this point. But there is no doubt that the merger's reduction of railroads from two to one in vast areas would cause substantial competitive harm. Accordingly, the Board must impose stringent conditions to ensure vigorous competition in such areas.

1. The Evidence on Competitive Impacts in Duopoly Markets Is Inconclusive.

The merger, if approved, would profoundly alter the structure of railroad competition in the western two-thirds of the nation, reducing service from three to two carriers for most of the large cities and traffic generating points between the Midwest gateways and the West Coast. Applicants, DOJ, and other parties, therefore, have presented evidence prepared by eminent economists on the issue of "competition among the few."

Willig, testifying for the Applicants, maintains that competition would be vigorous and even enhanced in markets served only by UP/SP and BNSF, post merger. UP/SP-23, VS at 577. He believes, for a host of reasons, that the railroads would be unable to successfully implement either unilateral or coordinated actions to raise prices, reduce output, and maximize joint profits. Id., at 582, 601-07. Opposing economists, citing both theory and studies of the effects of concentration on competition, insist that there is a strong likelihood of just such an outcome, largely due to enhanced opportunities for tacit coordinated interaction.

While the evidence of the merger's opponents often alludes to oligopoly practices, the basic issue involves duopoly competition. At a fundamental level, economic theory holds that the competitive outcome of duopoly is indeterminate.[21] In principle, competition can lead to a wide range of outcomes: from prices that maximize the joint profits of the duopolists to a competitive equilibrium. The result is determined by the degree of rivalry, i.e., whether the firms compete strongly or employ unilateral actions or tacit coordination to raise prices. Id.

Using that principle as a guide, DOT examined the economic evidence on the record. The evidence presented by Applicants' witness (Willig) and opposing economists consists almost entirely of theoretical discussions of how UP/SP and BNSF are likely to behave in the duopoly markets created by the merger. Willig, as noted, assesses the range of potential outcomes and maintains the behavior will be

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[21]/ This aspect of duopoly is acknowledged not only by Willig, but explicitly or implicitly by submissions of merger opponents. See Schmalensee (CR-22, VS at 6-7), Tye (RCT-4, VS at 8-11), White (KCS-33, VS at 113), and Grimm (KCS-33, VS at 194).

intensely competitive. Without exception, opposing economists allege the carriers are likely to pursue tacit coordination to produce monopoly, or near monopoly results; none investigates the potential for a competitive outcome in this particular case.

Opponents' positions on the instant merger are drawn from theory and models of firm behavior that lack empirical support. They support their statements with reference to a body of literature on industrial organization, showing that concentration at some point leads to higher prices. However, only a very few of these studies address the railroad industry, and their credibility has been seriously challenged; e.g., the use by Levin (and others) of "conjectural variation", (UP/SP-23, VS of Willig at 559-61), and MacDonald's work on grain prices (UP/SP-23, VS of Willig at 569-71; UP/SP-231, Rebuttal Verified Statement ("RVS") of Caron at 5-6, 9-12; UP/SP-231, RVS of Bernheim at 5-9). Majure, for the Justice Department, performed an analysis similar to MacDonald's using 1994 rail data, and it too has been subjected to serious attack. See Caron, supra, and particularly Bernheim's deposition at 62-64, 133-36.

Bernheim's own econometric study of UP rates in two and three carrier markets contradicted Majure's findings. UP/SP-231, RVS of Bernheim at 19-21. Bernheim 's study has in turn been challenged. Bernheim deposition at 1431.

In contrast to the conflicting theoretical analyses, evidence on the record shows that intense competition can exist in duopoly rail markets. The parties opposing this merger, as well as the Applicants, have provided extensive evidence of vigorous two railroad competition between UP and SP where their lines are parallel, extending to the use of build-in/build-out and transloading tactics to access shippers on each others' lines. E.g., UP/SP-23, VS of Peterson at 50, 61; WSC-11, VS of Jordan at 11; KCS-33, VS of Grimm at 169-70.

Moreover, increased concentration in the rail industry does not necessarily lead to higher prices. As the number of Class I railroads or railroad systems declined from twenty-six to ten between 1980 and the present, the average rail rate per ton declined more than thirty-eight percent on an inflation-adjusted basis, despite an increase in the average length of haul. See ICC Office of Economic and Environmental Analysis, Rail Rates Continue Multi-Year Decline (1995). For most of that time, up to the early 1990s, growth in rail traffic was stagnant. Also, for most of that period there were no more than four major railroads in the West and three in the East engaged in the east-west movement of traffic. Taken together these facts suggest that competition -- not just the act of deregulation, as alleged by KCS and DOJ -- may have driven railroads to pass productivity gains to shippers in the form of lower rates and more service for the freight dollar.

However, in DOT's view, none of the foregoing analyses, examining both sides of the duopoly issue, leads to a firm conclusion on the competitive outcome in markets in which the number of railroads goes from three to two. Therefore, mindful of ICC precedent that two railroads are often sufficient to maintain competition -- and the lack of dispositive evidence to the contrary on the record -- DOT recommends that the Board refrain from remedial action to maintain three railroad service in these markets.[22]

Nevertheless, the Department is not comfortable with the prospect that market efficiency across the Western United States after the merger would depend on the intensity of the rivalry between the two remaining railroads. Should the merger be approved, therefore, DOT believes it is of utmost importance that the Board take extraordinary care to assure that strong and effective competition is maintained in those markets where merger reduces the number of serving railroads from two to one.

2. The Magnitude of Traffic and Revenue Adversely Affected by the Merger Is Substantial, but Cannot Be Determined with Precision from the Evidence of Record

Because the scope of the Applicants' analysis was far too narrow, their estimate of the amount of traffic and revenue adversely affected by a loss of competition is understated. However, it is also DOT's view that the geographic markets defined by DOJ and KCS lead to a substantial overstatement of the competitive impacts for two-to-one markets.

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[22]/ BN/SF, slip op. at 94 ("Two independent railroads, we think, can provide strong, effective competition provided that, among other things, neither is subject to any artificial restrictions.").

a. Applicants' analysis

DOT considers the Applicants' assertion that the proposed merger would reduce rail competition only at points where currently UP and SP and no other railroad provides service is far too narrow a view of the competitive environment in the identified corridors. [23]

The record is replete with examples of UP and SP competing vigorously to tap the traffic of shippers on each others' lines in the Texas Corridors, through actual or contemplated build-ins/build-outs, transloading facilities, source competition, and even movement of rail cars by barge to a third rail carrier. E.g., UP/SP-13, VS of Peterson at 50, 61, 325-27; KCS-33, Vs of Grimm at 169-71. In the Central Corridor, a substantial share of Uinta basin (Utah) coal is already trucked from mines to either UP, SP, or Utah Railroad transloading facilities. WSC-11, VS of Jordan at 11. Applicants have, in effect, acknowledged the effectiveness of these forms of competition, amending the trackage rights originally proposed to give BNSF build-in/build-out rights to reach shippers on the lines of either UP or SP in the Texas Corridors, and the right to construct transloading facilities at points where the number of railroads is reduced from two-to-one.

Based on the evidence of record, we concur with the position of DOJ, KCS, SPI, Dow Chemical, Union Carbide and others that the merger would not only

[23]/ I.e., in the I-5 Corridor, in the Texas Corridors, and in the Central Corridor.

extinguish intramodal competition at commonly served points, but would also eliminate other forms of rail competition that provide shippers exclusively served by UP and SP competitive leverage to constrain UP and SP rail rates.

b. DOJ and KCS analyses

The Department believes that the DOJ and KCS analyses, identifying reductions from two to one in both independent rail routes and at common points, represent a generally correct approach for assessing the merger's effect on competition.[24] DOT also examines reductions in independent rail routings , sharing some of the decision parameters used by DOJ and KCS, but employing a more conservative definition of geographic markets.[25] However, the use by DOJ and KCS of broad geographic areas leads to a substantial overstatement of the traffic and revenues that would be adversely affected by the merger, in DOT's opinion.

Defining geographic markets to organize analysis of Rail Carload Waybill

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24/ KCS' witness, Grimm (KCS 33, VS at 185), quotes the ICC on this point:

> Competition between railroads generally requires the presence of two or more independent routes, that is, routes having no carriers in common. When a single carrier is a necessary participant in all available routes, i.e., a bottleneck carrier, it can effectively control the overall rate sufficiently to preclude effective competition.

Consolidated Papers, Inc., et al v. Chicago and North Western Transportation Company, 7 I.C.C. 2d 330, 338 (1991)

25/ DOT also differs in that it first examines total traffic, bi-directionally, between geographic markets to insure that any route carrying traffic will be revealed. Reductions in independent routes are then determined, followed by assessment of modal alternatives for commodities where independent routes are reduced from two-to-one or, in some situations, from three-to-two.

Sample movements, such as performed by DOJ, KCS ,and DOT, is necessarily somewhat arbitrary. Empirical data on commodity markets are not sufficiently detailed to verify the proper scope of the geographic market. KCS uses BEA to BEA geography exclusively; DOJ uses BEAs for most traffic and SPLC-4 (county) geography for the remainder. The Justice Department's assignment of commodities to BEAs or SPLC-4s, depending upon its conclusions on the extent to which each commodity can be moved to a railroad, is based on a broad judgment, supported only by a few examples.[26] The rationale used by both DOJ and KCS for selection of BEA markets is that a shipper captive to one railroad can dray his goods to another, competing railroad in the same BEA.[27] In addition, KCS appears to believe that the build-in/build-out option also spans a BEA.

At base the issue is whether constructing a build-out or draying across a BEA is a reasonable assumption. BEAs are generally large to begin with, ranging in size from ten to thirty counties. Particularly in the Western United States, where counties are

[26]/ DOJ states that they used a value-to-weight ratio to assign STCC commodities to BEAs or SPLC-4s, but evidence on the method used does not appear in the record.

[27]/ KCS cites a number of reasons for selecting BEAs as the relevant geographic market, but none of the reasons cited is uniquely associated with selection of the BEA; they apply with equal force to SPLC-4 geography, for example. In the same manner, the truck drayage used by DOJ applies equally to SPLC-4s.

even larger than in the East, BEAs tend to assume huge proportions. In the absence of supporting evidence to the contrary, it is DOT's view that analyses that discount the geographic expanse of these BEAs, where the distance between railroads could be hundreds of miles in some cases, lack credibility as a general proposition.

DOT's analysis of the 1994 Rail Carload Waybill Sample defined markets as traffic flowing between SPLC-4s, the equivalent of county-to-county movements. The shorter drayage distances involved make it a more credible assumption, and one that lends itself to the potential for build-in/build-out and transloading competition. DOT identified UP/SP markets where the number of independent rail routings and jointly-served points would go from two-to-one or three-to-two serving carriers if the merger were approved. Unlike DOJ and KCS, our examination took into consideration gateway competition, and, to the extent possible, the effects of the trackage rights agreements granted in the BNSF merger. Compared to DOJ and KCS, our analysis found fewer markets where competition would be reduced from two rail carriers to one. Moreover, where KCS (using BEAs) found the number of three-to-two markets produced by the merger exceeded the number of two-to-one markets, DOT (using SPLC-4s) found the number of two-to-one markets to be almost three times greater than the number of three-to-two markets.

Based on the foregoing discussion of Applicants', DOJ's, and KCS's analyses, DOT believes that the extent of the revenue and traffic affected by the proposed merger has not been, and cannot be, definitively determined on the record in this proceeding. For two-to-one markets, estimates of the affected traffic range from Applicants' (UP/SP-231, RVS of Peterson at 27), to DOJ's (DOJ-8, VS of Majure at 11), to KCS's (KCS-33, VS of Grimm at 193). Estimates of the traffic affected in three-to-two markets range from Applicants' (UP/SP-231, VS of Peterson at 24), to DOJ's

billion (DOJ-8, VS of Majure at 29), to KCS's (KCS-33, VS of Grimm at 193). Nevertheless, it is clear even from the Applicants' understated impact of

of affected traffic that reductions in competition would be extensive along the corridors where the number of serving railroads would be reduced from two-to-one by the proposed merger. Applicants clearly recognized that fact when they proposed that the STB grant BNSF trackage rights over the affected corridors as a condition on the merger.

V. TRACKAGE RIGHTS ARE GENERALLY INADEQUATE TO REMEDY THE COMPETITIVE CONSEQUENCES OF THIS MERGER

The record establishes that substantial losses of intramodal competition would be brought about by this merger. It is also clear that the volume and characteristics of traffic subject to this loss, and the enormous geographic distances covered by this loss, are unprecedented. In these circumstances, consistency with the public interest requires that the lost intramodal competition be supplied by railroads that are in every pertinent respect the competitive equals of the Applicants. However, service under traditional trackage rights would not permit this. Rather, such trackage rights introduce inequalities that, magnified by the circumstances of this case, are unacceptable.

A. The Original BNSF Trackage Rights Agreement

To ameliorate the anticompetitive effects of the merger, the Applicants negotiated a comprehensive trackage rights agreement with the BNSF. The agreement covers four large areas where UP and SP operations are largely parallel—the Central Corridor from northern California to Denver, Colorado; south Texas, which includes Mexican gateways at Eagle Pass and Brownsville; east Texas and Louisiana; and the Houston to Memphis corridor.[28] Other parallel areas include El Paso east to Sierra

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[28]/ Since Houston is the anchor to three important parallel corridors—Houston/Memphis, Houston/New Orleans, and Houston/Brownsville/Central Texas—we will refer to these

Blanca, Texas.

In addition, the Applicants agreed to sell various lines to BNSF. The most significant of these is from Iowa Junction, Louisiana to Avondale, Louisiana, which includes SP terminals in the New Orleans area; UP's line between Keddie and Bieber in California; and UP's line between Dallas and Waxahachie in Texas. UP/SP-22, VS of Rebensdorf at 311. BNSF would grant back trackage rights to UP/SP on the Iowa Junction-to-Avondale line and the Dallas-to-Waxahachie line. In sum, Applicants would grant BNSF trackage rights over 3,968 miles of line and sell to BNSF 330 miles of line in the affected areas.

The trackage rights compensation terms provided for in the agreement are paid solely on a variable basis depending on the gross tonnage that BNSF moves over the UP/SP lines. For bulk trains of 67 cars or more of one commodity in one car type, the fee is 3-mils per ton-mile. For intermodal and automotive trains, the fee is 3.48 mils per ton-mile for traffic moving from Keddie to Stockton, California and 3.1 mils on all other lines. Id. at 304.

The UP/SP would be responsible for all maintenance, dispatching, and supervision on the lines covered by the BNSF agreement. Id. at 306. Capacity-related improvements would be borne by the UP/SP for the first 18 months after the merger is

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corridors collectively as "the Texas Corridors."

approved. Subsequent improvements would be funded out of a $25 million capacity-related capital reserve account established with the proceeds from the line sales to BNSF. Id. at 309. Applicants assert that the BNSF agreement maintains two-railroad competition at all two-to-one points and preserves a two-railroad connection for all short line railroads that interchange with both UP and SP. Id. at 296-297.

Various parties in this proceeding raise significant issues concerning BNSF's ability to be an effective competitor in each of these markets as a tenant over UP/SP lines. Parties assert that the negotiated settlement agreement (1) would not grant BNSF access to sufficient infrastructure facilities to conduct operations for chemicals and plastics traffic; [29] (2) would prescribe costly compensation fees that would limit BNSF's ability to price competitively; [30] (3) would not ensure equality in dispatching,

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[29]/ CMA, DOW, NITL, SPI, and Conrail emphasize that chemicals and plastics shippers located in the Gulf area rely on storage in transit to operate production plants at capacity and to have the product readily available to move to end markets. (The Applicants agree. UP/SP-22, VS of Gray at 204; UP/SP-23, VS of Peterson at 65.) These parties allege that BNSF would be a limited participant in this market because it lacks sufficient facilities and yard capacity to meet these customers' service requirements, and as a result, would not be an effective competitor with UP/SP until it builds its own facilities. CMA-7, VS of Crowley at 40-41; DOW-11, VS of Crowley at 6-8; SPI-11, VS of Ruple at 17-19; NITL-9, VS of Crowley at 48-49; Conrail, CR-22, VS of Carey et al., at 40-41.

[30]/ Parties allege that the compensation terms in the BNSF agreement would impede BNSF's ability to compete and as a consequence lead to higher post-merger rail rates. They claim that BNSF would not have the flexibility to price its services over these lines because it would always face a price floor, limiting its ability to price competitively with UP/SP.

which would favor UP/SP (the landlord) trains over those of BNSF; [31] (4) would not grant BNSF access to traffic sufficient to justify operations; [32] and (5) would impede BNSF operations by precluding that carrier from participating in the directional traffic flows over the Houston/Memphis corridor planned by UP/SP. [33] These parties also

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DOJ-8, VS of Majure at 19-23; SPI-11, VS of Crowley at 5; KCS-33, VS of Plaistow at 191-93; SPI-11, VS of Shepherd at 46-47, 53; KCS-33, VS of White at 127. SPI, in particular, states that BNSF quoted Phillips Petroleum post-merger rates that were percent higher than current rates. <u>See</u> SPI-11, VS of Watson at V.S.6.

[31]/ Parties claim that UP/SP dispatchers would favor their trains over those of the tenant railroad, continually making the tenant's transportation services inadequate to meet shippers' demands, thereby making the tenant an ineffective competitor. CR-22, VS of Carey et al., at 47-51; DOJ-8, VS of Majure at 23-25; NITL-9, VS of Sharpard at 49-50; SPI-11, VS of Shepherd at 45; KCS-33, VS of Swanson at 52-53; KCS-33, VS of White at 127-29; International Paper ("IP")-11, VS of McHugh at 32.

[32]/ CMA, NITL, and SPI claim that the traffic open to BNSF under the trackage rights agreement would be insufficient for BNSF to conduct operations. SPI-11, VS of Crowley at 53-57; IP-11, VS of Prescott at 8-11. In addition, parties claim that much of the traffic is under contract and would be inaccessible to BNSF. SPI-11, VS of Shepherd at 44; NITL-9, VS of Shepherd at 48; CR-22, VS of McNeil at 7-8; CR-22, VS of Pileggi at 2-3.

[33]/ To obtain operating efficiencies from Houston to Memphis, UP/SP's operating plan calls for northbound trains to use the UP line while southbound trains will move on the SP line. BNSF was granted trackage rights on the SP line. In order to move trains from Houston to Memphis, BNSF would be “swimming upstream” against the UP/SP traffic flow. NITL-9, VS of Shepherd at 49-50; IP-11, VS of Prescott at 14-16; CR-22, VS of Carey, et al. at 16-19 and 80; SPI-11, VS of Shepherd at 45; KCS-33, VS of Rees at 230-31; IP-11, VS of McHugh at 28-29.

argue that the STB's approval of the merger would remove other benefits of two-railroad competition, i.e., build-in/build-out and transloading options, which shippers have used to hold rail rates in check even when they are served by only a single carrier. [34]

Parties state that the extent of these trackage rights, which encompass nearly 4,000 miles, is unprecedented and raises profound questions about whether BNSF could in fact, be an effective competitor to UP/SP over these lines. NITL-9, VS of Crowley at 30-40; CR-22, VS of Carey, et al., at 45-62; KCS-33, VS of Swanson at 251-66.

B. The CMA Settlement Agreement

Following these criticisms, the Applicants negotiated a more extensive agreement with the CMA in an attempt to respond to the parties' concerns. The CMA agreement would provide for storage-in-transit yard capacity for BNSF so it could

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[34]/ Parties have demonstrated that build-in/build-out and transloading options have been used to gain rate concessions from their serving carrier. KCS-33, VS of Simpson at 94-98; KCS-33, VS of May at 102-06; UCC-6, VS of Baxter at 4-7. Parties have also pointed out that if the merger is approved, any and all opportunities to exercise these options will be gone since only the carrier serving the line (UP/SP) will have control over these decisions. SPI-11, VS of Shepherd, at 44; KCS-33, VS of May at 107; CR-22, VS of McNeil at 8-9; CR-22, VS of Paranzino at 2-6; NITL-9, VS of Shepherd at 48; IP-11, VS of Prescott at 17-18.

conduct operations in the Gulf area; would open to BNSF fifty percent of the volume of contracts at UP/SP two-to-one points in Texas and Louisiana; would allow BNSF to conduct directional operations over the Houston/Memphis corridor to the same extent as UP/SP; would provide for an extensive protocol to ensure equality in dispatching; would create an account where the fees collected from trackage rights usage would be placed in a fund and used for capital improvements along those lines over which BNSF would have trackage rights; and would preserve shipper build-in/build-out options where economically feasible if the shipper petitions the UP/SP within one year after the merger is approved or their current contracts expire. UP/SP-219. The agreement also gives BNSF the right to handle traffic from Lake Charles, West Lake, and Shreveport, Louisiana and Texarkana, Texas/Arkansas. Id. In addition, the trackage rights would allow BNSF to operate from Memphis to St. Louis. The Applicants assert that the CMA agreement responds to concerns raised by parties and that it would ensure that the BNSF will be a potent competitor. UP/SP-230, at 12.

Not all the parties agree with the Applicants. SPI contends that the CMA agreement would not mitigate the loss of competition from the merger, and many of its concerns cannot be resolved unless UP/SP were required to divest one of the two parallel lines, including yards and facilities. Specifically, SPI charges that the trackage rights compensation fee structure, which the CMA agreement did not change, would still place BNSF at a competitive disadvantage with a merged UP/SP. SPI-16 at 8. [35] SPI also contends that BNSF has not shown an interest in competing in the affected area, as demonstrated by the fact that negotiations to modify the original trackage rights were undertaken by CMA, not the BNSF. Id.

Even though the procedural schedule did not allow parties opposing the merger to respond to the CMA agreement, it is clear to DOT that opposition remains. First, some CMA members consider the CMA agreement inadequate because it does not alleviate the cost disadvantages suffered by BNSF and does not address BNSF's lack of infrastructure except in a limited way. SPI-16, Exhibit 2. Second, NITL, which until the CMA agreement coordinated its participation in this case with SPI and CMA, has not reached an agreement with the Applicants, according to published reports.

C. The Department's Views on Trackage Rights

The Department believes that the extensive and unprecedented geographic scope of the problems presented by this merger, together with absence of any other Class I railroad in the affected areas in the West, compel the conclusion that even the augmented trackage rights solution proffered by the Applicants will not provide an adequate level of competition to shippers.

[35]/ The Applicants counter that BNSF's overall cost of handling traffic covered by the settlement agreement will be lower than SP's. UP/SP-231, RVS of Whitehurst at 6.

Trackage rights introduce a landlord-tenant relationship into railroad operations, and that structure has an inherent potential for problems between the landlord and tenant carriers that does not exist in the paradigm of competition: two "landlord" or owner railroads that compete with each other. The tenant may be at a disadvantage in myriad respects. First, the compensation generally, as here, varies with the amount of use. This structure may not permit the tenant the full range of pricing flexibility that a landlord enjoys, to set a rate at whatever level is necessary to attract traffic so long as it makes <u>any</u> contribution to fixed costs. Second, the landlord typically controls dispatching. This can be a particular problem where, as here, the tenant would be competing with the landlord. The greater the competition between the landlord and tenant, the more incentive the landlord would have to prefer its own traffic to the detriment of the tenant and its shippers. Third, new tenants may have difficulty breaking into a market when the landlord carrier has contracts of greater or lesser duration with shippers. Fourth, trackage rights generally (and here initially) do not provide access to infrastructure services and facilities. The record reflects that these are crucial in the transport of plastics and chemicals from the Texas Gulf. Fifth, trackage rights generally (and still here to a major extent) forbid tenant carriers to access new shippers, whether through the construction of spurs or any other means. Owner-railroads, of course, suffer no such constraints. <u>See</u> <u>generally</u>
CR-22, VS of Conway et. al., at 34-40; KCS-33, VS of Swanson at 251-253; CR-22,

VS of Schmalensee at 10-11 and 23-24.

The CMA agreement certainly improves upon the terms of BNSF's original access to the problem areas. It would set aside for particular purposes the compensation paid by BNSF, it would place a BNSF manager in the dispatching center of UP, it would permit the construction of build-ins and build-outs to shippers for a limited period, it would invite BNSF to participate in the directional flow planned by the Applicants for Gulf-to-Memphis movements, and it would provide some access to storage facilities for the chemical and plastic traffic in that region. UP/SP-219.

Although these modifications themselves break new ground and would make significant improvements to the prospective landlord-tenant relationship between UP/SP and BNSF, in the unprecedented circumstances of this case they are still inadequate, for several reasons. First, the structure of the compensation paid by the tenant would remain the same. [36] BNSF would still face incentives, cost structures, and restrictions different than (and competitively inferior to) the railroad against which it would be competing. Second, the CMA agreement does not extend to all the parallel lines that face a reduction in the number of railroads from two to one. The large numbers of shippers not covered by these modifications would remain subject to the

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[36]/ We note that the Applicants would accept "traditional" joint facility billing to allocate costs, if prescribed by the Board. Costs covered would be maintenance and operation of the joint facility on the basis of usage made by BNSF and UP/SP. UP/SP-231, RVS of Rebensdorf at 10, note 1.

terms of the original BNSF agreement, which, as indicated above, is substantially deficient. [37] Third, the CMA agreement would grant BNSF only one year's time to decide with shippers now served by either UP or SP whether to construct a spur and thereby receive intramodal competition. Landlord or owner railroads face no such time constraint. As market conditions change, so, too, may their commercial decisions; a competitor that cannot adapt to circumstances and strive for new business opportunities is a weaker competitor.

In addition to the deficiencies of the CMA agreement, DOT is troubled by BNSF's apparent ambivalence about its competitive role after the merger. BNSF's position has always been that the original agreement enabled it to be an effective competitor; however, no other party (perhaps not even the Applicants, as reflected in their subsequent settlement with CMA) has ever considered that agreement to be sufficient. Second, the improvements to its competitive posture came about through the efforts of CMA, not BNSF. Third, as noted by shippers, when pressed for price quotes post-merger, BNSF has apparently been reluctant to quote rates and service terms, and has only offered rates that may be significantly above current levels. SPI-11, VS of Watson at 6; IP-11, VS of McHugh at 26. Finally, since the outset of this proceeding, BNSF has taken no position on the merits of the transaction, and has

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[37]/ The Applicants have acknowledged that they would extend these conditions to all areas covered by the original BNSF agreement if so directed by the Board. UP/SP-230 at 20.

maintained that its original agreement with the Applicants would allow it to provide operations sufficient to meet shippers' needs. This remains BNSF's position. BN/SF-54, VS of Clifton at 2. It may be that BNSF is truly unconcerned about the outcome of this case, for it would remain the largest railroad if the STB disapproves the merger, and would gain access to 4,000 miles of track and traffic in the event of approval. It may find either outcome equally acceptable. From a public interest perspective, of course, it is problematic to depend upon such a carrier for the aggressive competition that is necessary here.

The specifics of this case also raise substantial questions about the efficacy of trackage rights, however modified, as a remedy. The distances involved --roughly 4,000 miles -- have never been approached or even attempted in any prior consolidation of Class I carriers, much less offered to a single carrier. [38] This poses a significant management task all by itself, and more so where, as here, the lines are often in areas where BNSF does not operate today. It is thus unsettled whether, even with the best of intentions, operations of direct competitors over thousands of continuous miles of shared track could proceed without significant risk. The CMA

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[38]/ For example, in the course of its own recent merger proceeding, BNSF offered nearly 2,100 miles of trackage rights to SP and much shorter distances to seven other railroads, but the total went "far beyond" that necessary to redress the competitive problems identified by the ICC. BN/SF slip op. at 83. That is not the case with the mileage agreed upon by the Applicants in this proceeding.

agreement does indeed address some of the concerns of the opposing parties and improves BNSF's ability to be an effective competitor along the parallel corridors. However, the CMA agreement cannot replicate the landlord-landlord competition that currently exists along these extensive areas.

Although trackage rights have been an effective remedy to mitigate competitive problems springing from past mergers, the sheer magnitude and extended geographic scope of the trackage rights proposals in this case magnify the inherent inequalities in the landlord-tenant relationship, and raise concerns about maintaining truly vigorous intramodal rail competition. The reduction in rail competition presented by the loss of an independent railroad here requires that the Board maintain the highest, most vigorous level of two-railroad competition possible throughout the affected areas.

VI. **DIVESTITURE IS NECESSARY TO PROVIDE THE** INDEPENDENT RAIL INTRAMODAL COMPETITION REQUIRED TO REMEDY THE COMPETITIVE LOSSES OCCASIONED BY THIS MERGER IN THE TEXAS CORRIDORS

Only equal competitors, with all the prerogatives, capabilities, and incentives of owners, can maintain the necessary two-railroad competition over the Texas Corridors here at issue. The Board must, therefore, order the Applicants to divest to unaffiliated railroads the lines in these corridors on which this competition is lost. Such a remedy would satisfy the STB's criteria for imposing conditions in merger proceedings.

One of the two parallel lines (UP's or SP's) in the Texas Corridors should be divested.[39] The record clearly demonstrates that other railroads have substantial interest in these lines; they generate large volumes of high margin traffic in an area that is geographically and operationally adjacent to many railroads, for example, KCS, Conrail, the Illinois Central, Norfolk Southern, CSX, and BNSF.[40] The lines connect with major gateways and serve major population centers. This suggests active "bidding" and subsequent vigorous competition between UP/SP and one or more additional landlord railroads. Moreover, there are no obstacles to divestiture of the Texas Corridors. Most of the public benefits claimed by the Applicants inhere in the Central Corridor , the I-5 Corridor, and other areas outside the Texas Corridors. CR-22, VS of Carey, et al., at 64-70. Therefore these lines could be divested without materially affecting the significant public benefits of the merger. See <u>BN/SF</u>, slip op. at 55-56; <u>UP/MKT</u>, 4 I.C.C. 2d at 437.

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[39]/ There is an exception to this recommendation for the Placedo to Brownsville line, on which SP currently operates with trackage rights over the UP line. Maintaining the status quo in this specific corridor will only require providing these same trackage rights to another carrier to replace SP.

[40]/ The record demonstrates that 38 percent of SP's carloads, other than intermodal, accounting for $627 million, are originated and terminated in the Texas Corridors. CR-22, VS of Malan at 6.

VII. AUGMENTED TRACKAGE RIGHTS IS THE PREFERRED REMEDY IN THE CENTRAL CORRIDOR

There are unique circumstances that militate against divestiture and in favor of augmented trackage rights in the Central Corridor. The Central Corridor is an area of extensive overlap between UP and SP -- approximately 1,400 miles. The Department's doubts about the efficacy of trackage rights over such vast distances remain; however, the record does not permit us to conclude with confidence that divestiture would produce the desired result (a capable, independent owner railroad) while maintaining adequate service to the public over the entire line.

There are several reasons for this. Although the area of overlap is large—from the Bay Area in northern California to west of Denver—there is a segment that generates relatively little traffic of its own—the Bay Area to Salt Lake City, Utah. Because this segment is therefore dependent upon overhead freight to maintain the Central Corridor as a viable independent routing, a railroad needs a network of gathering lines outside the area of overlap to generate enough density to support maintenance and operations. BNSF-54, VS of Owen at 15-16. Such networks are possessed only by SP, UP, and BNSF. The lack of such networks would almost inevitably cause the owner to concentrate service on the most viable portions of the Corridor, with other segments atrophying into candidates for abandonment. It is telling that the Western Coal Transportation League has requested the Board to order divestiture of the lines from Provo, Utah, east to a carrier other than the BNSF;

however, its proposed condition does not include the lines from Provo going west.

Montana Rail Link, Inc. ("MRL") has proposed to purchase the SP portion of the Central Corridor, but its application poses major problems. Foremost of these is that MRL does not possess the gathering lines in northern California to capture the traffic that would flow over the corridor. Second, its proposal extends well beyond the area of overlap of the UP/SP lines. [41] Third, MRL would face a significant competitive disadvantage, competing against two carriers in the West that could offer single line service to the major midwestern gateways. It is likely that much of the overhead traffic on the Central Corridor could be rerouted to other, single-line carriers, jeopardizing the viability of competitive service on that corridor. Together, these factors raise serious questions about MRL's application, going most importantly to its ability to supply vigorous competition, maintain adequate service to the public, and satisfy the traditional standards that closely tailor conditions to the problems created by mergers.

The Department therefore reluctantly concludes that divestiture is not the optimal solution for the problems caused by the merger in the Central Corridor. It

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[41]/ Broadly, other than its offer to purchase the Central Corridor, MRL proposes to purchase UP lines that run from north of Ogden, Utah, to Silver Bow, Montana; several UP and SP lines in California; SP's line over "Tennessee Pass" to Pueblo, Colorado; the line from Denver to Pueblo, Colorado; and UP's line from Pueblo to Herrington, Kansas. MRL-10 at 6-7.

would be possible, however, to strengthen the BNSF and CMA agreements so as to recast the landlord-tenant relationship between UP/SP and BNSF on the Central Corridor into the best approximation of a landlord-landlord relationship, with many of its attendant benefits. The first such change would be a two-tier trackage rights fee such as suggested by DOJ, where an up front "fixed fee" is intended to capture the fixed costs of operating over the line, followed by a usage fee representing the variable cost associated with the line. DOJ-8, VS of Majure at 20-23. The Department believes that this variation to the trackage rights compensation fee structure would more adequately ensure that the tenant carrier would be a committed competitor over this extensive area. It would have the same incentive to recover its investment and the same pricing flexibility as the landlord (UP/SP) it faced. Our second modification to the trackage rights agreements would preserve build-in/build-out and transloading options along the entire stretch of trackage rights without time limit. Again, BNSF would be in a position approximating that of an independent owner of the line. Third, as in the CMA settlement, the STB should order the Applicants to open their contracts with shippers on the Central Corridor at two-to-one points until the BNSF has access to fifty percent of the traffic. Finally, the Board should establish in advance formal annual procedures to review the effectiveness of the trackage rights so modified, and be prepared to order divestiture or transferal of the modified trackage rights to another railroad. If the Board is not prepared to modify these trackage rights in this manner, it should proceed to order divestiture of the Central Corridor.

VIII. CONCLUSION

The proposed merger would create the largest railroad in the United States. The precedent the Board's decision will set and its potential effects on the national railroad system, extent of the overlapping lines of the Applicants, and the absence of other Class I railroads in the West, requires the most strict scrutiny of the competitive consequences of this transaction. After careful review of the record, the Department has concluded that only divestiture of the Texas Corridors can replace the competition that is lost through the merger. Trackage rights, even as modified by the parties, are simply inadequate in the circumstances of this case to remedy the extensive problems created. The only exception to this rule lies in the Central Corridor, due to extraneous factors, and in that case we urge the Board to modify the trackage rights agreements proposed by the parties to place BNSF in a competitive position approximating the Applicants. Alternatively, if the Board is not prepared to strengthen the trackage rights, it should direct the Applicants to divest the Central Corridor as well.

Respectfully submitted,

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General Counsel

June 3, 1996